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Getting the Most Out of Public-Sector Decentralisation in Korea

Randall Jones*, Tadashi Yokoyama

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GETTING THE MOST OUT OF PUBLIC-SECTOR DECENTRALISATION IN KOREA

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By
Randall S. Jones and Tadashi Yokoyama

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ABSTRACT/RESUMÉ

Getting the Most Out of Public-Sector Decentralisation in Korea

This paper discusses policies to improve fiscal relations between levels of government to better meet the needs of citizens, an objective of the government's "Roadmap for Decentralisation". Although local government accounts for around half of total government spending, they have little autonomy and fiscal resources vary sharply between regions. The priority should be to enhance the independence of local authorities by establishing a clear division of responsibilities and transferring additional assignments to the local level. The general local governments should also have more influence on education, while providing more support, through stronger linkages with the local education authorities, with a final aim of merger. The allocation of intergovernmental grants should be more transparent and the regulations attached to them should be relaxed to expand flexibility, while increasing reliance on block grants. Improving the fiscal federalism framework also requires more revenue raising power for local governments while simplifying the structure of local taxes. Greater accountability and rules are needed to ensure sound fiscal management by local governments.

This Working Paper relates to the 2005 OECD *Economic Survey of Korea* (www.oecd.org/eco/surveys/korea).

JEL classification: HI, H2, H7, R58.

Keywords: Fiscal federalism, local government, intergovernmental grants, fiscal discipline, decentralisation, property tax, regional policies, Korea.

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Tirer le maximum de la décentralisation du secteur public en Corée

Ce papier examine les politiques qui visent à rationaliser les relations financières des différents niveaux d'administration pour mieux répondre aux besoins des habitants, comme le veut le plan de marche gouvernemental vers la décentralisation. Bien que les collectivités locales soient à l'origine de la moitié des dépenses publiques totales, elles n'ont guère d'autonomie et leurs ressources budgétaires varient fortement d'une région à l'autre. L'objectif prioritaire est de renforcer l'indépendance des autorités locales en clarifiant la répartition des compétences, en transférant d'autres tâches à l'échelon local et en fusionnant les autorités scolaires locales avec les autorités locales générales. L'affectation des transferts entre collectivités publiques doit être plus transparente et leur réglementation, assouplie, pour plus de flexibilité, avec en parallèle un recours élargi aux dotations globales. Pour rationaliser le fédéralisme budgétaire, il faut aussi que les collectivités locales puissent mobiliser davantage de recettes et, en même temps, simplifier la structure de la fiscalité locale. Ce chapitre recommande aussi un effort de responsabilité et des règles qui assurent une saine gestion budgétaire des autorités locales.
Ce Document de travail se rapporte à *l'Étude économique de l'OCDE de la Corée 2005* (www.oecd.org/eco/etudes/coree)

Classification JEL : HI, H2, H7, R58.

Mots clés: Fédéralisme financier, collectivités territoriales, transferts intergouvernementaux, discipline budgétaire, décentralisation, impôts immobiliers, politiques régionales, Corée.

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GETTING THE MOST OUT OF PUBLIC-SECTOR DECENTRALISATION IN KOREA

Randall S. Jones and Tadashi Yokoyama[1]

1. Korea is a unitary country with a short history of local autonomy. Policies to increase the role of local government, which have been linked to the objective of promoting regionally balanced development, began in the late 1980s. This has contributed to a rise in local governments' share of general government outlays to around one-half, a relatively high proportion compared to other OECD countries (Figure 1).[2] However, the benefits of decentralisation have not been fully realised. *First*, the historical legacy of centralised control has left excessive authority at the central level. In particular, the education budget is largely outside the control of local authorities. Moreover, weak self-governance and a lack of capability at the local level have limited the effective use of the power that they do have. *Second*, the severe imbalance in the financial resources of central and local governments requires local authorities to rely on large transfers from the central government, including earmarked grants. *Third*, there is a large variance in the fiscal independence of local governments, with local own-source revenue accounting for 95% of spending in Seoul compared to only 17% in lower-level cities. In sum, the current framework weakens the management of fiscal resources and makes it difficult for local governments to meet the demands of their constituents. In the longer run, reforming the relationship between central and local governments is an important aspect of controlling spending pressures while limiting the regional variation in fiscal capacities.

2. This paper identifies policy options to improve fiscal relations across levels of government. After an overview of the current situation, the following sections present the key issues related to spending, revenue and fiscal discipline. The fifth section considers the link between fiscal federalism and policies to promote balanced regional development. The paper concludes with an agenda for further reform.

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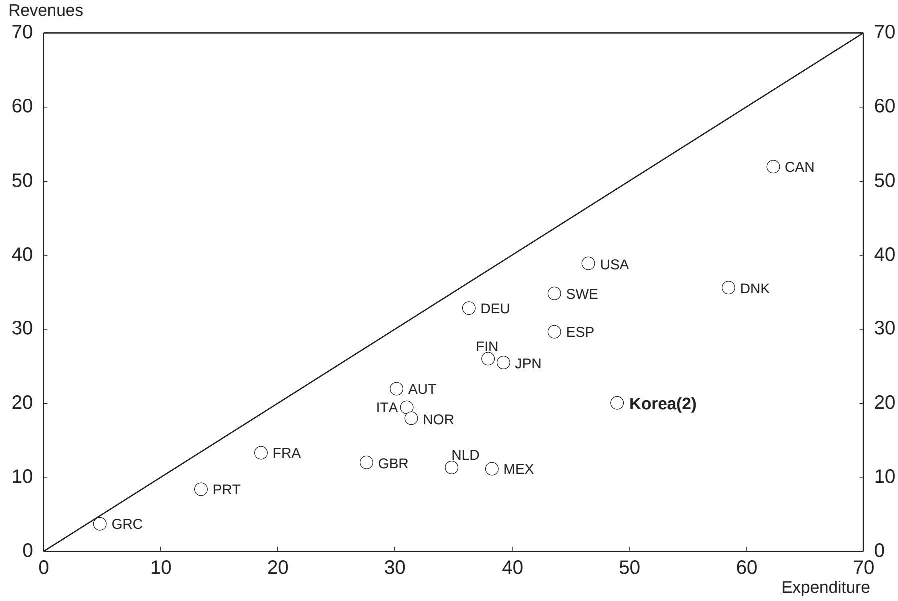
1. Randall Jones is head of the Japan/Korea Desk and Tadashi Yokoyama is economist on the Japan/Korea Desk in the Economics Department of the OECD. This paper draws on material originally produced for the *OECD Economic Survey of Korea* published in October 2005 under the responsibility of the Economic and Development Review Committee. The authors are indebted to Yongchun Baek, Andrew Dean, Christopher Heady, Isabelle Joumard and Val Koromzay for comments. Special thanks go to Brooke Malkin for technical assistance and Nadine Dufour for secretarial help.

2. On a consolidated basis, local general governments accounted for 33% of total government spending in 2004, with the local educational governments, which are independent of local general government (see Box 3.1), accounting for another 12%. Subtracting intergovernmental transfers from central government spending boosts the local government share to around 50%.

Figure 1. Sub-national government share in general government revenues and expenditure
Per cent in 2003(1)



Note: Revenues include direct and indirect taxes as well as non-tax revenues received by regional and local governments and are expressed as a share of revenues received by the general government. Expenditure corresponds to total expenditure by regional and local governments expressed as a share of general government expenditure. Transfers between governments are netted out. The country ranking in this figure does not necessarily correspond to the comparative fiscal autonomy of sub-national governments.

1. Or latest year available: 2000 for Japan, 2002 for Denmark, Korea and Mexico.
2. Including local education governments.

Source: OECD, National Accounts database; Statistics Norway; Statistics Canada; US Bureau of Economic Analysis.

The trend toward fiscal decentralisation

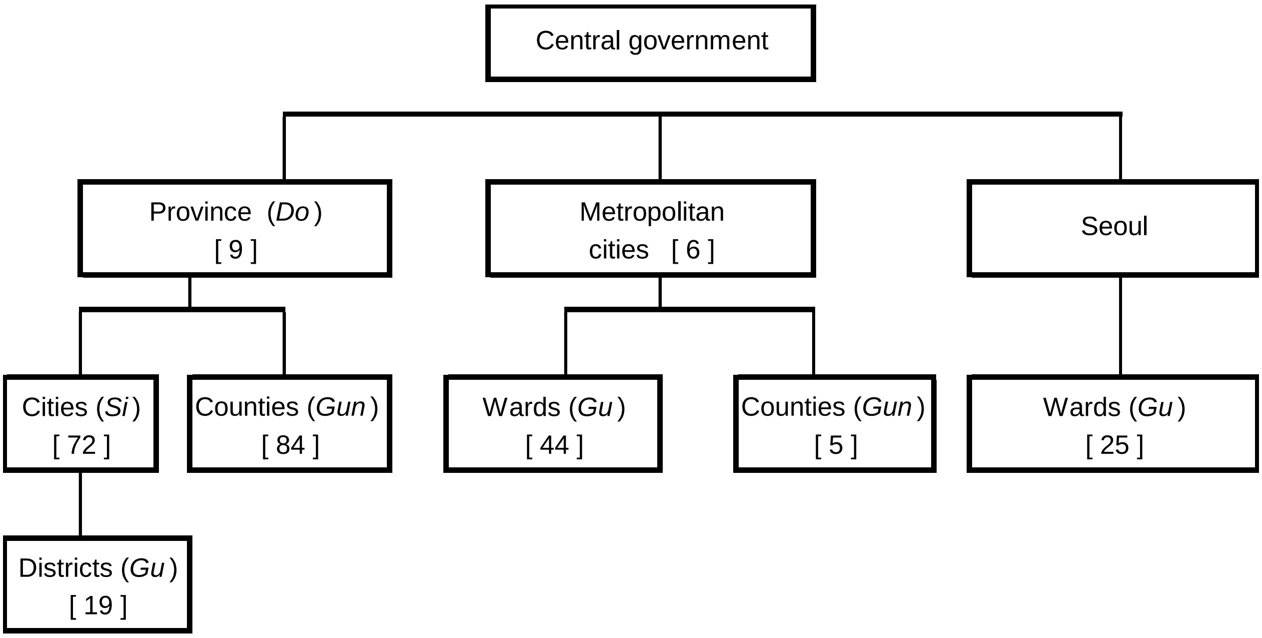
3. Korea was governed by a highly centralised administrative system until the late 1980s, with local governments acting as little more than branches of the central government. However, the reform of the Local Autonomy Act and the Local Finance Act in 1988 launched the shift of responsibilities to sub-national governments. This was followed by the introduction of a directly elected local council system in 1991, followed by the popular election of governors and mayors in 1995 (see Box 1). These reforms, which were in line with the world-wide trend toward decentralisation, were aimed at satisfying the pressure for greater democracy and meeting the increasing demands of local citizens. In addition, greater local autonomy was expected to promote more balanced regional development. Fiscal decentralisation appears to have enhanced the quality of public services by increasing flexibility, allowing them to reflect local needs and demands more closely (Kwon, 2003).

Box 1. The structure of local government in Korea

There are basically two levels of local government in Korea. The upper-level government consists of nine provinces, six metropolitan cities and Seoul special city (Figure 2). Urban areas are separated out from their surrounding provinces and designated as metropolitan cities once their population approaches one million. These cities have the same status as provinces. Lower-level governments are subdivided into the administrative units of cities, counties and wards, and include legislative assemblies. Authority for education is located in the Offices of Education in the provincial and metropolitan governments (see below). The major spending areas of local general government in 2002 were; general administration (16.3%), health and living environment (15.7%), development and preservation of resources (14.8%), social assistance (10.8%), education and culture, excluding the local education government's outlays in this area (10.8%) and housing and regional/social development (10.5%).

Figure 2. Korean local government system

December 2001



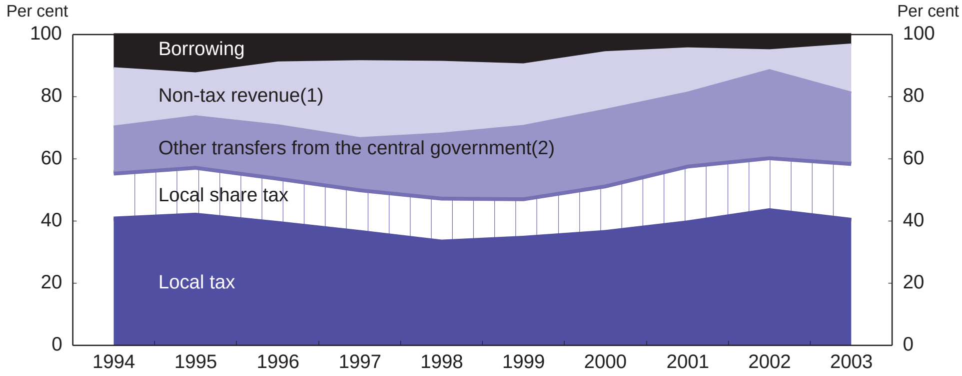
Note: Korean terms are in italics. The number of units is in brackets.
Source: Ministry of Government Administration and Home Affairs.

The constitution grants local governments the right to manage their property and affairs and to enact their own regulations within national laws. More specific responsibilities are defined in the Local Autonomy Act, which designates the following "autonomous affairs" to be handled by the local authorities: *i)* the organisation and management of local governments; *ii)* the promotion of citizens' welfare, including social facilities and assistance for disadvantaged persons; *iii)* industry promotion; *iv)* local development and management of facilities such as roads and water supply; *v)* promotion of education, athletics, culture and the establishment of childcare centres; and *vi)* local civil defence and fire fighting. The central government is to maintain only a passive role in these autonomous affairs.

There are also "delegated functions", which are entrusted either to local governments or to local chief executives. Responsibilities delegated to local governments, such as vaccinations and the maintenance of national roads and public health centres, are subject to specific laws. In principle, expenditures are jointly borne by the central and local governments, and the local governments also receive earmarked grants. Responsibilities delegated to local chief executives include the registration of residents, administration of referendums, policing and promotion of commerce and industry. Such expenditures are financed by earmarked grants, with the national authorities playing an active role in their implementation.

On the revenue side, local taxes and transfers from the central government each fund about 40% of local expenditures (Figure 3). Transfers are divided between the Local Share Tax, which is set at a fixed share of national tax revenue, and National Subsidies and the Local Transfer Fund, which are primarily earmarked grants. Non-tax revenue - income from local public enterprises, public land development and various user charges - is also significant. Local funding sources, including tax and non-tax revenues, account for slightly more than half of local outlays. Finally, borrowing by local governments has funded a shrinking share of local spending in recent years.

Figure 3. Funding of local government expenditures
As per cent of total



1. Calculated as a residual, setting local government revenue equal to expenditure. The large amount of carryover included in non-tax revenue made reported local government revenue about 40% higher than spending over the decade 1994 to 2003.
2. National Subsidies and the Local Transfer Fund.

Source: Ministry of Government Administration and Home Affairs.

The government's reform plan

4. The government considers decentralisation to be necessary for competing in a globalised world, creating a knowledge-based economy and promoting the development of civil society. The current administration has thus adopted decentralisation and balanced regional development as major items on its policy agenda. In 2003, it created the Presidential Committee for Government Innovation and Decentralisation (PCGID),[3] which identified a number of problems in this area.

- *Excessive central government authority and intervention in local government affairs*. The role of local government has been limited to implementing centrally-determined policies and programmes as directed and guided by central government ministries and agencies.
- *A large imbalance in fiscal resources between the central and local governments*. Consequently, local jurisdictions are largely dependent on the central government, which tends to treat them as administrative units rather than as independent legal entities. Funding relies to a large extent on earmarked grants, giving the central government effective control over a wide area of local policies.
- *Weak capabilities at the local government level and little participation by local residents*. Rather than bringing government closer to people as hoped, the participation rate in local elections has been declining (Kim, 2004). In addition, there has been a marked increase in corruption charges against elected local officials from 23 between 1995 and 1998 to 49 between 1998 and 2002.

3. In addition to the main Committee, which has 20 members, the PCGID includes six executive committees, task force teams, an advisory board, an office of planning and management, and various subcommittees.

5. The Committee's "Roadmap" for reform (see Box 2) includes many measures that are to be implemented by 2006. The guiding principles are to demonstrate confidence in local governments and transfer greater resources and responsibilities to them. Although some major changes have been introduced, such as the elimination of the Local Transfer Fund and the creation of the Special Account for Balanced National Development in 2005, implementation is still at an early stage. Moreover, there are a number of issues that need to be further addressed to realise the full benefits of decentralisation.

Box 2. The Roadmap for Decentralisation in Korea

1. Reallocate authority between central and local governments

- Overhaul laws concerning decentralisation to establish clear criteria for allocating responsibilities between central and local governments.
- Implement an extensive transfer of central government authority to local levels.
- Enhance local autonomy in education through increased linkages between local general government and educational authorities and participation by residents.
- Introduce a local police force system.
- Consolidate the special local administrative offices, which hamper local government autonomy.

2. Implement sweeping fiscal decentralisation

- Expand local financing capacity, in part by transferring national taxes to the local level, and correct inter-regional imbalances.
- Overhaul local tax administration and promote more active use of the scope for tax-rate flexibility.
- Strengthen autonomy in local public finances by reforming the grant system and eliminating the requirement for case-by-case approval of local bond issues.
- Ensure the transparency and soundness of local fiscal management.

3. Enhance local government's capacity for autonomy

- Strengthen the legal framework for local government autonomy, including urban planning.
- Increase the quality of the local civil service through education, training and personnel exchanges.

4. Revitalise local legislatures and overhaul the local election process to reverse declining turnout

5. Strengthen accountability in local governments

- Balance increased autonomy with greater accountability through democratic oversight and an improved evaluation system.

6. Revitalise civic society and expand their participation in local civic affairs

7. Secure co-operative intergovernmental relations

- Strengthen collaboration between central and local governments and between local governments and improve mediation to resolve intergovernmental conflicts.

Source: Presidential Committee for Government Innovation and Decentralisation (2003).

Issues in the allocation of spending responsibilities

De facto control by the central government

6. The ambiguous division of responsibilities between levels of government allows the central authorities to effectively control spending by local governments. Although the Local Autonomy Act defines central and local expenditure responsibilities in general terms, the nearly 4 000 ordinances, regulations and laws governing public services determine the roles of local and national authorities in practice. As these tend to differ from the Local Autonomy Act, the distinction between central and local functions is unclear. In addition, central and local government functions overlap in areas such as labour affairs (including vocational training and counselling), the environment, construction and maintenance of roads and providing support for SMEs (OECD, 2003).[4] The overlap in responsibilities is accepted by local authorities, who are accustomed to centralised control (Kim, 2004). The importance of "delegated functions" adds further ambiguity to the assignment of tasks.

7. Local governments are required to follow the annual budget guidelines set by the central government, which set unit costs for very detailed expenditure categories.[5] The guidelines were changed to "budget criteria" from 2005, allowing local governments to set unit costs for some spending categories. However, the wages of local officials are still controlled by the central government. Central control is also exercised through the conditions attached to National Subsidies, which are provided for a wide range of local public services, concentrating in the areas of health, welfare, construction, transport and agriculture. In addition to being earmarked for specific areas, the grants are conditional on local governments complying with detailed operational standards, thus restricting flexibility. Local authorities are not allowed to carry over funds to following years or to transfer funds between grants, even though they are often for small amounts and for similar purposes, thus reducing their ability to respond to local conditions and leading to sub-optimal spending patterns over time.

8. The scope for allowing local authorities more flexibility in spending decisions, for example by shifting from earmarked to block grants (see below), appears to be limited by a lack of capacity at the local level to take on additional responsibilities (OECD, 2005b). Moreover, there is little incentive to do so as local public officials receive no additional salary corresponding to these extra tasks. Changing the historical legacy of centralised control requires not only institutional reforms, but also a transformation of the administrative culture of local officials and an improvement in their quality, in part through personnel exchanges with other governments units, both local and central, and the private sector. The recent introduction of an open competitive hiring system for certain positions should be used to bring in private-sector experts.

Exploiting scale economies by redesigning the geographical coverage of local public services

9. Local governments typically face difficulties in efficiently providing public services that are characterised by scale economies, are redistributive by nature and may affect residents from other jurisdictions. Korea has only 250 lower local government jurisdictions (Si, Gun and Gu) following the

4. There have been efforts to redefine expenditure responsibilities more clearly in recent years. In 1999, the Presidential Commission on Devolution Promotion to Local Authorities was established and it decided to transfer 1 090 central government functions to local jurisdictions by the end of 2001. However, less than half of the functions had been transferred by 2004. Nevertheless, a 2005 survey by the Commission found that the devolution has reduced the number of required documents and the cost of issuing licenses.

5. For example, the category of public employee compensation has ten expenditure items such as basic salary, bonus, family allowance, meal allowance, transportation allowance, etc.

merger of some cities and counties in the mid-1990s.[6] Consequently, their average size - at nearly 200 000 inhabitants - is relatively large in area and population compared to other OECD member countries (OECD, 2005b). For example, the average population of Japan's 3 000 municipalities is less than 50 000.

10. Nevertheless, some lower-level governments in Korea may be too small to exploit economies of scale and scope in providing some public services. Almost half of Korea's cities and counties have less than 125 000 persons.[7] Voluntary associations of local governments to provide public services offer a flexible approach to exploit scale economies. However, such associations are relatively rare in Korea, with about 60 at present. Voluntary associations must be reported to the Ministry of Government Administration and Home Affairs (MOGAHA), which sets minimum requirements for their establishment. Their effectiveness has been limited by a lack of prior approval by local councils, which in some cases have overturned the projects of voluntary associations. In addition, there has been a problem with weak management and a lack of follow-up and inconsistency with policies in participating jurisdictions. Finally, some aspects of the Local Autonomy Act and the intergovernmental transfer system appear to create disincentives for such associations (OECD, 2001).

Independent local education governments

11. Responsibility for primary and secondary education is vested in Education Boards and Offices of Education, which are located at the provincial and metropolitan city level but remain separate from local general governments. The authority to make decisions related to education belongs to the Boards, while the Offices of Education play an executive role. The head of each Office is elected, primarily by teachers, although parents and civil society have a limited role.[8] Compared to local general governments, the local education governments are more dependent on transfers from the central government, which account for 71% of their budget.[9] In contrast, the share of own resources, such as admission fees, tuition and local bonds, is less than 10%. The remaining 19% of the education budget is provided by local general government through the Local Education Tax (see below) and a fixed share of local tax revenue.[10] Despite this support, the head of the local education governments are granted autonomy in formulating their budgets. The discrepancy between the spending responsibilities and funding capacity has limited the development of autonomy in education and discouraged financing efforts by the local general

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6. In 1995, 41 cities and 39 counties were merged into 40 cities and the areas of three metropolitan cities were revised. Since then, there have been only minor changes in the number of municipalities.

7. In the case of Japan, for example, the unit cost of local public services was found to be lowest for municipalities of around 125 thousand persons (Yoshida, 2003).

8. Only teachers with more than five years of experience are allowed to be candidates. There are also 180 lower-level Offices of Education whose heads are nominated by the provincial and metropolitan city-level Offices. The lower-level Offices are also independent of lower-level general governments.

9. Transfers from the central government consisted of three components until the end of 2004. The most important (79% of the total) was the *Local Education Share Tax*, which is a block grant financed by a fixed share (13%) of national tax revenue (excluding earmarked taxes and duties). The *Local Education Transfer Fund*, which was financed by an earmarked national tax, provided an additional 20%. The remainder, about 1%, was from National Subsidies. In December 2004, the Transfer Fund was abolished and offset by an increase in the Local Education Share Tax to 19.4% of national tax revenue.

10. Prior to 2005, the transfer was set at 3.6% of provincial and municipal tax revenue. In addition, local governments provided "teachers' salary transfers", which covered 100% of salaries in Seoul, 50% in Busan and 10% in other metropolitan cities and Gyeonggi Province. In 2005, the share of local tax revenue transferred to the educational authorities was raised to 10% in Seoul, 5% in other metropolitan cities and Gyeonggi Province and left unchanged at 3.6% for other local governments, while the teachers' salary transfers were abolished.

governments. In most OECD countries, in contrast, local governments are primarily responsible for implementing education policies.

Issues in local government funding

12. With tax and non-tax revenues covering a little more than half of their outlays, local governments rely on large transfers from the central government (Figure 3). There is a wide variation in the financial autonomy of local jurisdictions. While Seoul is virtually self-financing, 62% of local governments cannot even fund the salaries of local officials from their own revenues. This implies a need to increase transfers from the central government to limit inequality, although such an approach does not increase local government autonomy. On the other hand, enhancing revenue autonomy of local governments would have a negative impact on regional equity by widening the gap in fiscal capacity between regions. Therefore, the main challenge on the funding side is to provide local governments with sufficient revenue-raising autonomy to make them accountable to local citizens and encourage fiscal discipline, while ensuring that all have sufficient revenue capacity to provide at least a minimum level of core public services.

A complex local tax system that limits the autonomy of local authorities

13. The local tax system, which has accounted for about 20% of total tax revenue in Korea during the past decade,[11] is relatively complicated with 16 local taxes (see Box 3). This contrasts with a much leaner local tax system in Nordic countries - at most four local taxes in Finland, Iceland, Norway and Sweden - which, like Korea, are unitary countries with a high share of local government in total public spending. A basic principle of Korea's tax system is the separation of tax bases between central and local governments to avoid excessive taxation on particular items.

11. This is slightly above the 18% average of other unitary countries in the OECD, though well below the 35% average of the federal countries.

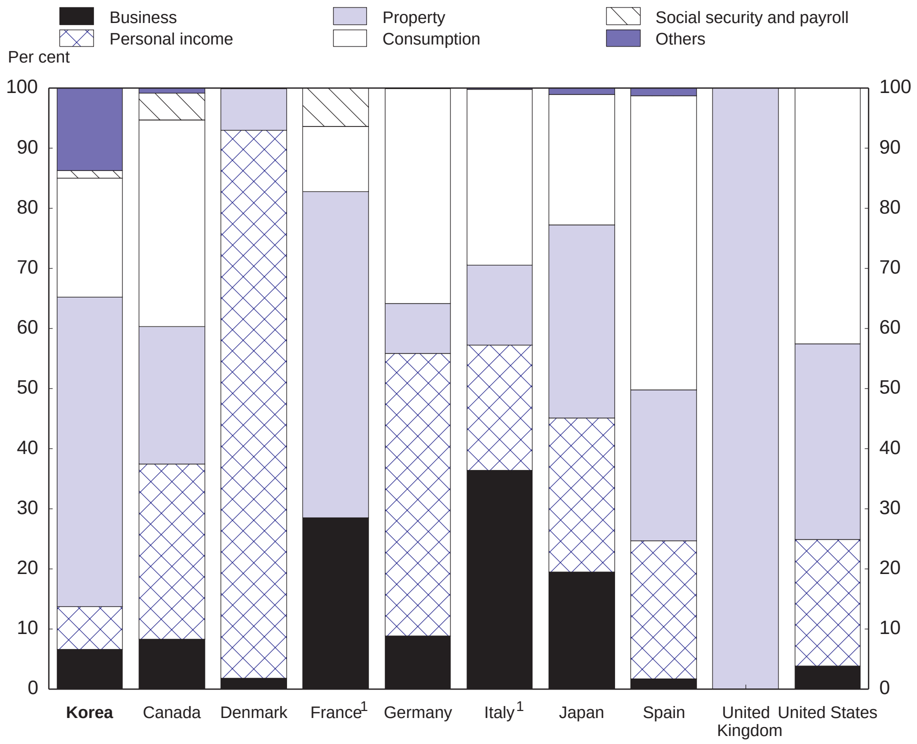
Box 3. The local tax system

Local taxes generated 32 trillion won (4½ per cent of GDP) in 2003. In the metropolitan cities and Seoul, 13 of the 16 taxes are imposed at the upper level of local government, while three are administered by lower-level units.* In the provinces, the situation is reversed: seven of the taxes are imposed at the upper level, with the remainder at the lower level (Table 1). Thus, some taxes imposed at the upper level in the metropolitan cities, such as the automobile tax, are imposed at the lower level in the provinces. Nine key taxes generated 88% of local tax revenue. The large number of minor taxes, each generating less than 3% of local tax revenue, reflects the reliance on earmarked taxes. However, one of the earmarked taxes, the Local Education Tax, is a major revenue source. It was introduced in 2001 as a surcharge on five local taxes, but is transferred directly to local education governments and thus does not enhance the autonomy of local general governments (Kim, 2003 and 2004).

Property taxes account for about half of local tax revenue (Figure 4). However, taxes on consumption, business and personal income and social security and payroll taxes were relatively insignificant compared to other OECD countries.

Figure 4. Composition of sub-national government tax revenues

2003



1. Including other taxes paid solely by business (Taxe professionnelle in France and IRAP in Italy).

Source: *OECD Revenue Statistics*, 1965-2003.

* Prior to 2005, there were 17 local taxes. However, the Comprehensive Land Tax was merged into the Property Holding Tax in 2005.

Table 1. The local tax system in Korea

Tax	Revenue in 2003	Share of total	Permitted range of tax rates	Actual range of tax rates	Tax imposed by			
	Billion won	Per cent			Provinces		Metropolitan cities[1]	
					Upper level	Lower level	Upper level	Lower level
Property registration	7 550	23.5	1-3%	2%	x		x	
Property acquisition	5 503	17.1	1-3%	2%	x		x	
Inhabitants,[2] of which:	4 558	14.2	5-15%	10%	x		x	
Individual	2 356	7.3	5-15%	10%	x		x	
Corporate	2 202	6.8	5-15%	10%	x		x	
Local education[3]	4 009	12.5	5-90%	10-60%	x			x
Tobacco consumption	2 384	7.4	--	641 per pack	x			x
Automobile	1 778	5.5	40-330 won/cc	80-220 won/cc	x			x
Comprehensive land[4]	1 603	5.0	0.2-5.0%	0.2-5.0%		x		x
Motor fuel[5]	1 266	3.9		21.5%	x			x
Urban planning	999	3.1	Below 0.23%	0.15%	x			x
Property holding	903	2.8	0.035-6%	0.07-4.0%		x		x
Leisure	896	2.8	--	10%	x		x	
Common facilities	411	1.3	0.025-0.26%	0.05-0.13%	x		x	
Business office	104	0.3	Below 0.5%	0.5%		x		x
Regional development	103	0.3	5-15 won/10 m^3	10 won/10 m^3	x		x	
Licence	65	0.2	--	3 000-45 000 won		x	x	
Butchery	44	0.1	0-10%	10%	x			x
Agricultural income	4	0.0	--	3-40%	x			x
Total	32 180	100.0			13	4	7	10

1. Including Seoul.
2. The standard rate is 10% of the national personal income tax and corporate income tax.
3. A surtax on five local taxes: Registration, Leisure, Automobile, Tobacco, and Inhabitants.
4. The Comprehensive Land Tax was merged into the Property Holding Tax in 2005, leaving 16 local taxes. Of these, three are levied at the lower level of provincial governments and nine at the lower level of metropolitan cities.
5. A surtax on the national Transportation Tax.

Source: OECD, Network on Fiscal Relations across Levels of Government.

Strong reliance on property taxation

14. The large share of property taxes in local tax revenue is primarily due to the Acquisition Tax and the Registration Tax, which generated 13.1 trillion won (1.8% of GDP) in 2003 - 40% of total local tax revenue.[12] In contrast to transaction taxes, taxes on holding property (the Comprehensive Land Tax and Property Holding Tax) contributed only 2.5 trillion won. The relatively small amount reflects a tax base set at around 30% of market value, resulting in an effective tax rate of 0.12% (Table 2). Altogether, recurrent taxes on property generate revenue amounting to less than 0.5% of GDP, well below the 1.9% average in the OECD (Figure 5).

Table 2. Changes in property holding taxes

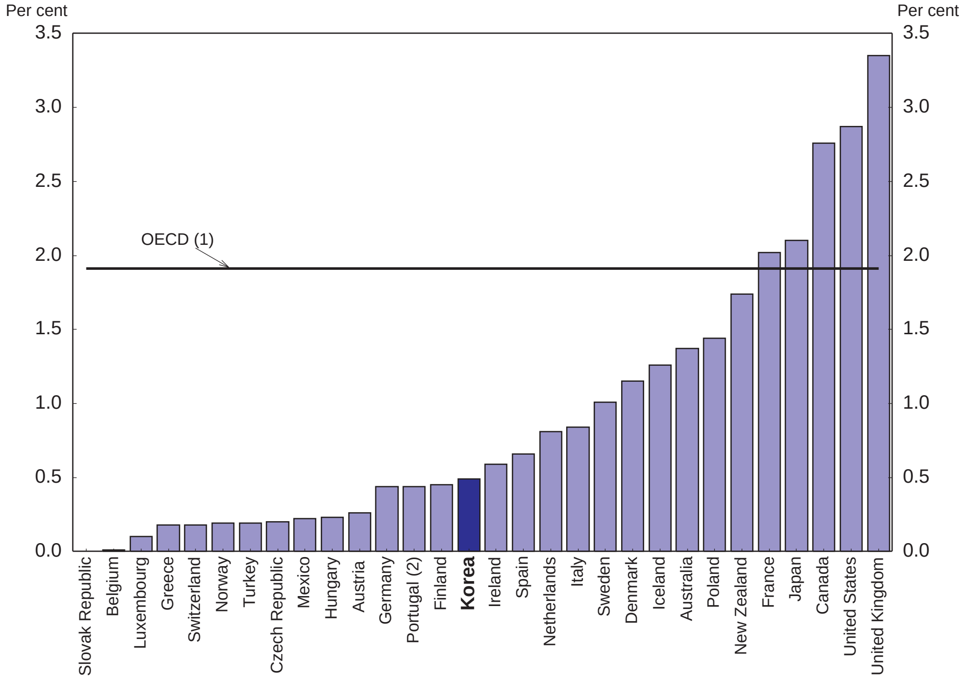
	2003	2004	2005 and after
Housing	A local tax, levied on individual buildings	No change	Two taxes: Local tax[1] National tax[2]
Tax base	Standard construction cost (170 thousand won/m²) Adjusted by the size	Standard construction cost (180 thousand won/m²) Adjusted by market value[3]	50% of the combined value of building and land[3]
Tax rate	6 rates (between 0.35% and 6%) depending on the size of the tax base	No change	3 rates (between 0.15% and 0.5%) depending on the size of the tax base
Land	A local tax (Comprehensive Land Tax), with help from the central government)	No change	Two taxes: Local tax, levied on individual land holdings National tax[2]
Tax base	36.1% of the standard market value[4]	39.2% of the standard market value[4]	50% of the standard market value[4]
Tax rate	9 rates between (0.2% and 5%) depending on the size of the tax base	No change	3 rates (between 0.2% and 0.5%) depending on the size of the tax base

1. Beginning in 2005, the land used for a building is no longer taxed under the Comprehensive Land Tax, but is instead taxed as part of the Property Holding Tax.
2. The “Comprehensive Property Tax”, which is imposed on an individual’s total property holdings, at a progressive rate between 1% and 4%.
3. Based on a survey by the National Tax Service. The target is set at 80% of the market value.
4. Based on a survey by the Ministry of Construction and Transportation. The standard market value is thought to be 80% to 90% of the market value.

Sources: Ministry of Government Administration and Home Affairs and the Ministry of Finance and Economy.

12. The total tax rate for real estate transactions was 5.8% (2% for the Acquisition Tax, to which 0.2% is added for the Special Tax for Rural Development, and 3% for the Registration Tax, to which 0.6% is added for the Local Education Tax).

Figure 5. Recurrent taxes on immovable property in OECD countries
Revenues as a per cent of GDP in 2002



1. Weighted average using 2000 GDP and purchasing power parities.
2. 2001.
Source: *OECD Revenue Statistics*, 1965-2003.

15. Property taxation is theoretically more advantageous than other taxes as it is levied on immobile assets, thus limiting the scope for tax evasion. Moreover, to the extent that it is based on asset values, it conforms to the benefit principle. However, there are a number of problems with property taxation in Korea.

- It acts as a barrier to liquid property markets and efficient land use as it is largely imposed on transactions rather than on ownership of property.[13]

- Economic growth in a local jurisdiction creates little additional local tax revenue because tax revenue from property transactions is only loosely related to income increases.[14] Instead, the revenue depends on real estate market conditions, thus undermining the stability and predictability of local tax revenues.

- Tax rates and valuation methods have been largely determined by the central government, which set an "application ratio" that averaged 36% of the "standard market value". While the application ratio was not legally binding, most local authorities accepted it because lowering it would significantly decrease revenue while raising it would cause taxpayer resistance.

13. In addition, a national tax on capital gains is levied in order to discourage speculative transactions.

14. Kook (2004a and 2004b) argues that the relationship between local tax revenues and local income is very weak due to high dependency on property transaction taxation.

- Since the regional disparity in the property tax bases is larger than that of income taxes, the strong reliance on property taxation aggravates regional disparities.

- The low rate on property ownership encourages landholding for speculative purposes and does not encourage efficient use of land.

- Holding taxes tended to be regressive as they were adjusted for building size rather than market value.

16. Acknowledging that the structure of property taxation tends to undermine efficient land usage, encourage landholding for speculative purposes and impair equity, the government plans to boost the effective tax rate on property holdings to 0.24% in 2008, 0.5% in 2013 and 1.0% in 2017 by raising the valuation closer to the market value. In 2005, the application ratio was raised to 50% of the standard market value, while lowering the permitted range for the tax rate in order to prevent a sudden rise in tax liabilities (Table 2).[15] However, some local governments in the capital region have lowered tax rates in order to reduce the property tax burden. To restrict speculation on real estate and increase progressiveness, the government introduced in 2005 the “Comprehensive Property Tax” on individuals’ nation-wide holdings, at a rate of between 1% and 4% depending on the cumulative value.[16] All of the revenue from this tax is to be returned to those local governments whose tax revenues decline due to this change or whose financial status is weak. The combined effect of these reforms is expected to increase revenues from taxes on holdings of land and buildings by 2.6 times between 2003 and 2008. The increase in property holding taxes was accompanied by a reduction in the tax rate on property transactions from 5.8% to 4.6% (4% on transactions between individuals). However, the effective rate on transactions was actually increased because the tax base was raised to the standard market value.[17]

Local governments do not use the existing scope for flexibility

17. The Local Tax Act defines the tax bases and standard rates for 16 local taxes. Local governments are allowed to adjust rates, by as much as 50% above or below the standard rate, for 11 of 16 local taxes. However, this power has been rarely used. At the provincial/metropolitan city level, only four of 16 jurisdictions had changed a tax rate from its standard rate as of 2004, and only ten of the 250 lower-level local governments. As noted above, though, a number of local governments reduced the rate on the property holding tax in 2005 as assessments were brought closer to market levels. In contrast to the limited use of tax flexibility, local governments grant tax reductions and exemptions as part of regional development policy (Hong, 2003).[18] The share of tax expenditure in total local revenue was 10.3% in 2000, thus reducing transparency.

15. The regressive nature of the tax on buildings was also ended by making the tax base depend on market value rather than on size.

16. The amount paid for the local property tax will be deducted from the amount of the national tax. The government expects 60 thousand persons to pay this tax in 2005, generating revenues of 0.7 trillion won.

17. Previously, the tax was officially based on the transaction price, but in practice was similar to that used for the property holding tax, *i.e.*, about 30% of the market value.

18. Tax reductions and exemptions must be announced in municipal ordinances and approved by MOGAHA.

18. The limited use of tax-rate flexibility in Korea conflicts with the principles of fiscal federalism and the situation in some other OECD countries. In particular, more variation in taxes on enterprises would be expected, as companies are more mobile than property. Several factors may explain the absence of tax competition. *First*, it is widely believed that lowering tax rates would lead to reductions in grants, although there is no direct link between tax rates and the amount of grants provided by the central government (see below). *Second*, local governments tend to demand increases in intergovernmental grants - rather than raise tax rates – when they want to boost expenditures (OECD, 2005b). *Third*, local governments hesitate to diverge from norms set by the national authorities, given the central government's control over local taxes and outlays. *Fourth*, local authorities fear taxpayer resistance to higher tax rates.

Increasing local governments' revenue powers

19. Increasing local government revenue-raising powers would allow them to better respond to local citizen preferences and help ensure fiscal discipline by making the cost of local public services more visible for local taxpayers. One priority, as noted above, should be to substantially increase revenue from property holding taxes, although this should be partially offset by a reduction in property transaction taxes. The government is considering the creation of a tax on facilities such as nuclear power plants and waste disposal sites. However, this approach would further complicate the already complex local tax system, without providing much revenue for most jurisdictions, and would likely widen regional disparities. Another option is to establish a local share of the VAT as was done in Japan in 1997. However, such an approach did not enhance local autonomy as local authorities are not allowed to adjust the rate of the VAT, which is collected by national authorities. Instead, greater reliance on taxes for which local authorities can set the tax rate would increase their revenue powers while enhancing autonomy.

Large intergovernmental transfers

20. Transfers from the central government fund another 40% of local government expenditure (Figure 3). They thus play an extensive role in closing the gap between local government spending responsibilities and revenue capacity, as well as narrowing the large variation in fiscal capacity between local governments. Indeed, per capita fiscal expenditure is higher in low-income regions (Moon, 2003). Among these transfers, the largest is the *Local Share Tax* (LST), a national equalisation scheme aimed at equalising vertical and horizontal imbalances, which covered 18% of local government spending in 2003. Revenues transferred through this grant have been fixed at 15% of national tax revenues (excluding earmarked taxes and customs duties). *National Subsidies*, earmarked grants which provide funds for a wide range of local public services, covered about 17% of local spending in 2003. The *Local Transfer Fund* (LTF), a block grant fund introduced in 1991 to promote balanced regional development and to supplement local investment, financed 5% of local outlays.

21. In 2005, there was a major reform of intergovernmental transfers:

- The government re-organised National Subsidies, resulting in the transfer of 163 programmes to local governments, with total spending of 1.1 trillion won, about a quarter of the total.[19]
- The Local Transfer Fund (LTF) was abolished.[20]

19. This is funded by a transfer of 0.83% of national tax revenue to local governments through the LST. In general, the shift from earmarked National Subsidies to the LST block grants is appropriate, except when spillovers between jurisdictions are significant.

20. The LTF was a mixture of block grants and a tax-sharing system between the central and local governments that was funded by fixed rates of domestic tax revenues (100% of the Liquor Tax and 14.2%

- The share of domestic taxes reserved for LST, a block grant, was increased from 15% to 19.1%, boosting funding by 4 trillion won (0.6% of GDP) and offsetting the loss of funds from the LTF.
- The Special Account for Balanced National Development (SABND) was created.

The Local Share Tax

22. The LST is the main equalisation scheme. The allocation of the "ordinary" portion of the LST is based on criteria that measure the difference between fiscal needs and capacities, as in many other OECD countries, to calculate the fiscal shortage (Box 4). Calculation of the *Ordinary LST* has been criticised on a several grounds: *i)* the complicated and non-transparent method of calculation, including 31 criteria and the arbitrary setting of adjustment coefficients (Kook, 2004a and 2004b); and *ii)* the inclusion of variables, such as the number of local government officials and administrative districts, which are under the control of local governments.[21] The complicated formula leads many local officials to believe that the amount of LST that they receive will be reduced if they raise local tax rates. It also leads to erratic fluctuations in the standard fiscal needs calculation, which make it difficult for local government planning.[22] In addition, the calculation of the *Special LST* is criticised as being discretionary and non-objective. Recognising that the LST is too complicated, the government reduced the number of criteria slightly to 26 in 2005. In addition, the calculation of the standard fiscal needs formula has been revised in order not to penalise local governments that make savings, such as cuts in the number of public officials and current expenditures, although it still includes some variables decided by local governments.

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of the National Transportation Tax). Although the LTF helped to expand local infrastructure, it was criticised for its rigid management. In particular, the rationale for investing a fixed share of the Liquor Tax was unclear as its link to local infrastructure was weak. In addition, the artificial division of the fund into many categories based on a fixed formula was criticised as an example of rigid management of earmarked revenue (Kim, 2004).

21. In contrast, in several other OECD countries, such as Norway, only those criteria that cannot be directly manipulated by local governments are included in the formula.

22. For example, the standard fiscal need of counties jumped 41.5% in 2001 followed by a 9.7% rise in 2002. Another element of uncertainty is the fact that total LST outlays are set at a fixed share of national tax revenue, which may fluctuate considerably.

Box 4. The Local Share Tax

The Local Share Tax for each jurisdiction is determined by its *fiscal shortage*, calculated as the difference between its standard fiscal need (SFN) and its standard fiscal revenue (SFR). The SFN is calculated using a complicated formula that takes into account demographic, geographic, social and economic characteristics in 12 categories and 31 sub-categories. Population and size of the jurisdiction are the most important characteristics in the formula. These needs are combined with the unit cost of each sub-category, after adjustment for special factors.

SFN = Basic fiscal demand + Supplementary demand + Demand incentive

Basic fiscal demand is estimated as:

$BD = \Sigma(m,p,c)$ where m is the measurement unit, p is the unit cost and c is an adjustment coefficient

Supplementary demand adjusts for the amount of a local government's contribution to the education special account. The demand incentive is used to induce local governments to cut spending by reducing the number of officials and other measures.

The calculation of the SFR is as follows:

SFR = Basic revenue + Supplementary revenue + Incentive revenue

Basic revenue is set at 80% of estimated tax revenue to encourage local government to raise revenue. Supplementary revenue includes factors such as: *i)* 80% of earmarked tax revenue and user charges; *ii)* 100% of general grants from upper-level governments; *iii)* 50% of the difference between forecast and actual local tax revenue two years ago; and *iv)* 50% of the difference between the forecast amount of general grants two years ago and the actual amount. The incentive revenue is used to compensate for the impact on basic revenue when a local government changes a tax rate from the standard rate. However, the process of calculating the incentive revenue is not legally binding. This ambiguity leads local governments to believe that efforts to boost their tax revenue reduce the amount of the Local Share Tax that they receive (Kim, 2003).

The sum of fiscal shortages across jurisdictions is usually more than the amount of funds available for the LST, which as noted above, is a fixed share of national tax revenue. Consequently, an adjustment factor is applied to the shortage of each local government to determine their allocation.

In addition to the Ordinary LST, a portion of LST funds is set aside for the Special LST. This fund is distributed to local governments for priority projects such as housing, disaster relief and to meet the special needs of regions. While the Special LST is allocated to all local governments, ten did not qualify for the Ordinary LST in 2002. The share of the Special LST was reduced from 9.1% to 3.65% in 2004 by converting part of it to Ordinary LST.

The creation of the Special Account for Balanced National Development (SABND)

23. Regional development objectives will be pursued by the SABND, which consists of 153 programmes aimed at ensuring minimum national standards for public services and promoting regional innovation. The account tries to improve efficiency of intergovernmental transfers through an integrated, comprehensive and local-demand based approach compared to the more fragmented, programme-oriented and central government-based strategy of the past. SABND, with total spending of 5.5 trillion won (0.7% of GDP), has three main components: *i)* formula-based projects (2.6 trillion won), which are allocated autonomously based on factors such as the population, size and fiscal capacity index of local governments; *ii)* projects for poor regions (1.0 trillion won); and *iii)* regional innovation projects (1.9 trillion won), which are allocated by the central government in response to requests from local governments. The grants, which range in size from 0.5 billion to 534 billion won, are financed by the Liquor Tax, congestion charges, transfers from the general account and a couple of special accounts. Matching grants are the main form of financing. The matching rate ranges from 30% to 100%, with 50% the most common.

24. Despite some similarities with National Subsidies, which are also matching grants, there are certain unique elements in the SABND (Kim, 2004 and Lim, 2004). *First*, the discretionary power of the line ministries in deciding the allocation of funds is reduced as nearly half of the SABND grants will be formula-based. Moreover, to allow local governments to spend these funds in line with their specific priorities, they are given flexibility to shift them to other purposes and are permitted to carry over up to

20% of the total budget during a specified time period. *Second*, the projects supported by the SABND have to compete with each other, given that local governments have some scope to choose their preferred set of projects. The line ministries are thus forced to make their programmes attractive to local governments. *Third*, most of the SABND programmes are executed in connection with the five-year National Balanced Development Plan and the National Fiscal Management Plan to ensure overall consistency. *Fourth*, local governments must develop their planning skills as they are not given unconditional rights to spend the full amount of SABND funds allocated to them. If they do not provide reasonable plans to use these resources, only part of the fund can be carried over to the following year, and unspent funds will eventually be reclaimed by the central government.

25. Despite these positive elements, there are a number of weaknesses in the SABND grants (Lim, 2004):

- Around a quarter of the projects were transferred from the National Subsidies programme in which many of the details were specified by the central government. Consequently, line ministries will maintain considerable influence.
- The characteristics of projects are not fundamentally different from those in the National Subsidies programme.
- Local governments will have to deal with a larger number of ministries than in the case of National Subsidy grants.
- Local governments appear slow to make creative plans that match their citizens' needs due to a lack of planning ability and weak incentives to accept additional responsibility as noted above.
- The SABND aims to address simultaneously the policy goals of balanced regional development (equity) - where it overlaps with the LST - and regional development (efficiency).

Securing fiscal discipline in a decentralised setting

26. Local government debt amounted to 2.3% of GDP in 2004, well below the 25% figure for the central government. Local debt has been tightly controlled and stable,[23] even in the aftermath of the financial crisis, which contributed to a substantial run-up in central government debt from less than 9% of GDP in 1996. The stability reflects strict central government control of local government borrowing.[24] Nevertheless, local governments are allowed to incur debt in certain cases, subject to approval by the Ministry of Government Administration and Home Affairs (MOGAHA) on a case-by-case basis (Box 5).

27. Local debt consists of loans (86%) and bonds (14%). The central government and public funds provide almost all loans, making the role of private financial institutions relatively unimportant (Table 3). The central government makes many types of special accounts and public funds available for local government borrowing. The most important is the *Public Capital Management Fund*, which is funded by the surpluses on government pension schemes, postal savings, and other funds. Another important central

23. Nevertheless, some local governments have a significant level of debt. For example, Busan's debt was 117% of its annual tax and non-tax revenue in 2001, and it would have exceeded 250% if the debt of the Busan Transport Authority were included. In the case of Seoul, the subway debt was more than double the city government's debt in 2001 (Kim, 2003).

24. The fact that the share of local government bonds in total local expenditure decreased after 1996, the year following the introduction of popular elections of governors and mayors, suggests that the central government succeeded in controlling the debt of local governments.

government fund for local borrowing is the National Housing Fund, which issues national housing bonds. A part of this Fund is then loaned to local governments to build low-cost public housing.

Table 3. Local government debt
In 2001 trillion won[1]

A. Borrowing from:

Government	Public funds	Financial institutions	Foreign borrowing	Subtotal
10.4 (58.6%)	4.2 (22.6%)	0.5 (2.6%)	0.4 (2.2%)	15.3 (86.1%)

B. Bonds by type:

Compulsory bonds	Regular bonds	Foreign bonds	Bonds in lieu of payment[2]	Subtotal
1.3 (7.1%)	0.8 (4.6%)	0.4 (2.1%)	0.0 (0.1%)	2.5 (13.9%)

1. Numbers in parenthesis show share of the local government debt of 17.8 trillion won.
2. This is basically a way of postponing payment to contractors for public works.

Source: Ministry of Government Administration and Home Affairs.

28. As for bonds, the most important category is compulsory bonds (Table 3), which must be purchased as part of certain transactions such as the purchase of cars, the registration of construction machinery and urban land development. The revenue thus raised is earmarked for subway construction and urban development. In contrast, regular bonds purchased in the market account for less than one-third of total local government bonds. The fact that the central government places strict restrictions and controls on local government borrowing, while at the same time subsidising it, has limited the development of a local debt market. Given the rising demand for investment in urban infrastructure, it will be increasingly important to link local borrowing with the long-term capital market. The plan to replace the approval system for individual local bonds in 2006 with a total ceiling on bond issues is likely to encourage a greater role for market-based borrowing. However, this raises concern about whether there would be adequate fiscal rules, which are currently rather lenient (see Box 5), to ensure sound financial management.

29. The soundness of the fiscal position is clouded by the uncertain financial links between the government and public enterprises. There is a risk that local government debt could be significantly boosted by the liabilities of public enterprises. In particular, the debt of subway companies in the major metropolitan cities amounted to around two-thirds of local government debt in 2001, despite central government transfers that partly mitigated the burden of subway construction. In sum, strengthening market forces requires disclosing adequate information on local government's repayment capacity.

Box 5. Rules on debt financing by local governments

Local governments are allowed to incur debt, subject to approval by MOGAHA, in the following cases: *i)* construction of public facilities; *ii)* projects generating profits large enough to repay the debt; *iii)* disaster recovery and prevention projects; *iv)* debt repayment; and *v)* other projects that permanently improve the welfare of residents. On the other hand, MOGAHA explicitly forbids debt financing for current expenditure, facilities whose service life is very short and small projects. Debt issuance by local governments should also be consistent with MOGAHA's Medium-term Local Finance Plan. The criteria for determining what projects are appropriate are strict in principle but can be arbitrary in practice.[1]

In addition, local governments must meet the following criteria to receive permission from MOGAHA for debt financing. *First*, they have not delayed the repayment of debt. *Second*, debt repayment as a share of general revenue over the preceding four years averaged less than 20%.[2] *Third*, the ratio of the budget deficit to general revenue is not more than 10%. *Fourth*, projected local tax revenue is not less than 90% of the total in the previous year. *Fifth*, issuance of debt has been consistent with the original application sent to MOGAHA. The local government then submits the plan to the local council, which determines the final amount of debt to be issued. Local councils can approve an amount less than that approved by MOGAHA but they seldom do so, reflecting the fact that local debt is viewed not so much as a future tax burden but as a form of central government assistance.

1. MOGAHA sends guidelines to local governments every year to provide guidance as to which projects justify increased debt.
2. Debt repayment includes interest payments, while general revenue is defined as local tax and non-tax revenue and general grants (Local Share Tax).

Table 4. Fiscal independence of local government

A. The share of own-source revenue in total revenue by type of local government (per cent)

	Seoul	Metropolitan cities	Provinces	Cities	Towns	Special districts
Average	94.5	68.8	41.3	38.8	16.6	42.6
Highest	94.5	72.7	78.0	70.4	48.6	92.7
Lowest	-	54.6	14.2	12.3	7.1	19.4

B. The distribution of the share of own-resource revenue of local governments

Per cent of total revenue	Prefectures	Cities	Towns	Special districts	Total	Per cent of total
Less than 10%	0	0	10	0	10	4
10-30%	7	32	72	15	126	50
30-50%	1	30	6	46	83	33
50-70%	3	14	0	3	20	8
70-90%	4	1	0	2	7	3
Higher than 90%	1	0	0	3	4	2
Total	16	77	88	69	250	100

Source: Ministry of Government Administration and Home Affairs.

The link between fiscal decentralisation and policies for balanced regional development

30. As noted above, fiscal decentralisation has been aimed in part at mitigating the concentration of population and economic activities in the capital region and to achieve balanced regional development. With about 22 million people - 48% of the country's total - the concentration in the capital region (Seoul, Incheon and Gyeonggi province) is one of the highest in the world, resulting in congestion and pollution costs (see the 2005 *OECD Economic Survey of Korea*). Its dominance is even more pronounced in terms of fiscal resources, accounting for 71% of personal income tax receipts and 85% of corporate income tax receipts in 2003.[25] Average per capita local tax revenue in the capital region is more than 60% above the national average, resulting in wide regional variations in the share of own-source revenue in local government revenue (the fiscal independence index). While Seoul is almost independent, with own revenue accounting for 95% of total revenue, the average for the metropolitan cities is 66% (Table 4). Moreover, the averages for provinces, cities and towns are less than 50%. Indeed, own-source revenue accounted for less than half of total revenue in 84% of local governments (Panel B).

The government's decentralisation policy did not succeed in stopping concentration

31. The authorities have implemented numerous measures since the 1970s to reduce concentration in the capital region (see Box 6). However, as in the case of other OECD countries, including Japan, these policies have not been successful (OECD, 2005c). Indeed, the share of the population has risen from 28% in the early 1970s to nearly half at present, in part due to the shift from manufacturing to service industries. In addition, measures of regional inequality appeared to have increased since 1990 (Moon, 2003).

Box 6. Policies to limit concentration in the capital region

The government has implemented a wide range of policies to foster balanced regional development:

- Development activities have been regulated by the Capital Region Rearrangement Act. Large-scale construction projects, such as new towns and industrial complexes and tourist facilities, which may increase the concentration of population in the capital region, requires prior approval of the committee on Capital Region Rearrangement.
- The construction of large facilities in the capital region is restricted by imposing quotas on manufacturing industries and universities and by levying congestion charges on large business buildings in Seoul.
- The "Relocation Promotion Measures" announced in 1999 provide large financial incentives, such as tax reductions and/or exemptions and loans, to firms that move out of the capital region.
- Economic activity in underdeveloped areas is promoted through the creation of regional industrial parks.

The authorities have also tried to mitigate overcrowding in the capital region by relocating central government functions. In the mid-1990s, ten agencies were moved to Daejeon, the largest city in the middle of Korea. This was followed by legislation in 2004 to create a new administrative "capital" in Chung Cheong Province (OECD, 2005b). However, the Constitutional Court declared that the legislation was unconstitutional. The government then proposed the Special Act on Construction of the Administrative City, which was enacted in 2005. In contrast to the 2004 plan, Seoul will remain as the capital and home to the legislative and judicial branches, as well as the president. According to the revised plan, 49 government agencies, including 12 ministries, will be relocated by 2014. The population of the new city is targeted at 500 thousand by 2030. In addition to the new administrative city, the government plans to move 176 public organisations outside of the capital region by 2012. The locations are to be decided by September 2005 with construction to start by 2007. This plan would reduce the proportion of public organisations located in the capital region from 85% at present to 35%.

25. According to Moon (2003), regional inequality in terms of per capita regional GDP in Korea is similar to that in other OECD countries such as France and Germany. However, it should be noted that the regional GDP data in Korea do not appear to fully represent income differences between regions (OECD, 2001).

32. These efforts to limit concentration - to the extent that they have been effective - have been costly. The continued growth of the capital region indicates that the high costs of locating there are outweighed by the benefits, such as economies of agglomeration resulting from proximity to the nexus of business activities. There is evidence that some sectors benefit from the spatial concentration of people, firms and information. Indeed, more than two-thirds of venture companies are located in the capital region, which offers high-quality human capital, excellent universities, and an attractive living environment. However, the limits on construction in the capital region make it difficult for these businesses to expand beyond the incubation stage (Kim and Son, 2004). Regulations restricting investment and new businesses in the capital region limit the economic benefits of agglomeration and conflict with the objective of maintaining rapid economic growth.

33. Given the continued trend toward concentration and the cost and ineffectiveness of current policies, the administration adopted balanced regional development as a major policy objective along with fiscal decentralisation. Major initiatives to promote balanced regional development include:

- The launching of the Roadmap for Decentralisation (see Box 2) and the Presidential Committee on National Balanced Development in 2003.

- The creation of the Special Account for Balanced National Development in 2005 (see above).

- The proposed construction of a new administrative city to host a large number of major government offices (see Box 6).

At the same time, the regulations on construction in the capital region have been relaxed for SMEs, venture businesses, foreign-invested companies and advanced-technology firms. Moreover, the restrictions on building factories, schools and tourist facilities in the capital region are to be relaxed beginning in 2006.

Implications for fiscal decentralisation

34. Fiscal decentralisation, which aims at the efficient provision of local public services, does not necessarily match with the objective of balanced regional development. Nevertheless, policies aimed at these two objectives have been closely tied together in Korea. Mixing these two policy goals could lead to significant efficiency problems. For example, some of the policy directions aimed at providing more autonomy may exacerbate regional differences. In particular, greater reliance on local tax revenues will further widen the gap in fiscal capacity between regions, as noted above. However, this could be offset by the greater use of a well-designed block grant system to limit the regional variation in income levels, as well as a shift in responsibility to local authorities. In particular, the funding of local public services, notably education, through grants provided by the national government, transfers significant fiscal resources to rich regions (Kim, 2004). For example, the city of Seoul, which does not receive Ordinary Local Share Tax because of its high income level, is receiving educational grants from the central government. If Seoul were to transfer more revenue to the Seoul Education Office, then a higher proportion of education grants from the central government would be available for less wealthy regions. Therefore, stronger linkages between the local education authorities and the local general governments, with a final aim of merger, are needed to induce the local general governments to invest more resources in education. This, in turn, will increase local autonomy and efficiency.

Conclusion

35. Despite the progress in decentralisation since the late 1980s, overcoming the historical legacy of strong control by the central government and the limited role of local governments requires further reform. The comprehensive programme launched in 2003 is a step in the right direction. However, achieving the full benefits of liberalisation requires other initiatives as discussed above and summarised in Box 7.

Box 7. Summary of recommendations for fiscal decentralisation

Increase the capacity of local governments to handle greater responsibility for taxes and spending

- Facilitate personnel exchanges between levels of government and with the private sector.
- Provide incentives for local civil servants to accept more responsibility.

Enhance the autonomy of local governments and increase efficiency in spending programmes

- Establish a clear division of responsibilities between levels of government and minimise “delegated functions” to allow local governments independence in carrying out their tasks.
- Facilitate the creation of voluntary associations of local governments, in part through changes in the regulatory framework and the grant system, to provide public services more efficiently.
- Transform earmarked grants, including National Subsidies and those provided by the SABND, to block grants, except in cases where spillovers make earmarked subsidies the better approach.
- Relax the conditions attached to earmarked grants to allow more flexibility to local authorities.
- Allow local authorities to carry over grants to the future and permit some scope for shifting funds between projects to enhance their discretion and independence from line ministries.
- Make the definition of standard fiscal needs and standard fiscal revenues in the formula for the Local Shared Tax more simple, transparent and based on objective criteria, while limiting discretionary elements.
- Strengthen linkages between the local education governments and local general governments, with a final aim of merger, to increase local autonomy for education.

Increase local governments’ revenue powers

- Simplify the complicated local tax system by eliminating some of the 16 existing taxes and avoid the creation of new local taxes.
- Encourage the use of existing flexibility to set tax rates and make clear that changing tax rates does not influence the level of transfers from the central government.
- Reduce reliance on taxes on property transactions, which account for about 40% of local tax revenue, in order to reduce lock-in effects and encourage the efficient use of land.
- Accelerate the plan to raise the effective tax rate on property holding from 0.1% at present to 1% by 2017 by bringing the tax base in line with market values.
- Use property holding taxes as the primary source of additional local tax revenue, along with other taxes that enhance local autonomy.
- Ensure adequate public services throughout the country by making sure that the transfers from the central government to poor local governments are sufficient as tax powers are transferred to local jurisdictions.

Ensure fiscal discipline of local governments

- Design appropriate fiscal rules for local governments as the central government approval system for individual local government bond issues is abolished in 2006.
- Reduce local governments' reliance on loans from the central government and public corporations, while increasing the role of market financing.
- Phase out the use of compulsory bonds.
- Strengthen accountability of local governments and increase transparency about their financial position, including contingent liabilities related to local public corporations.

Separate regional development policies from fiscal decentralisation policies

- Increase the tax autonomy of local authorities, while using well-designed intergovernmental transfers to limit regional income disparities.
- Finance local public services through block grants that take account of the fiscal capacity of local governments.
- Shift away from regulation to limit concentration in the capital region in favour of market-based measures that address the externalities of pollution and congestion.

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